1) Introduction

The growth of the Brazilian economy during President Lula’s tenure (2003-2007) has been limited and uneven, far below the Latin American average and further below the average of other “emergent” countries such as China, India and Russia. Such performance cannot be ascribed to international conditions – quite the contrary, those have been exceptionally favorable. Its causes have to be sought internally.

Given the uncertainty inherent to a development process, growth is facilitated if there exists a “development convention” – if social actors partake of an agenda which defines the hierarchy of problems to be solved and the hierarchy of solutions to those problems. In other words, if there is a “development project’ which reduces uncertainty and induces coordination of the strategies of the social actors. From its very beginning the Lula government recognized the need for a development project and, in fact, put forward several proposals, discussed below. Such abundance of proposals is self-defeating for the purposes of uncertainty reduction and agent coordination.

This paper argues that both phenomena – slow and uneven growth and lack of a development project – have a common root: the dominance of economic policy by a coalition of interests structured by high interest rates. Such financial dominance is
expressed by the monetary and fiscal policies led by the Central Bank and the Finance Ministry and justified in terms of price stability, which is posed as a pre-condition to any development project.

Since “history matters” and path-dependency plays a major role in our argument, the next section sets the stage of the beginning of the Lula government, outlining the political and economic factors which surrounded his election in 2002 and the ensuing uncertainty at the beginning of the government in 2003.

Section 3 examines the different strategies of development proposed by the Government at the beginning of the two mandates, in 2003 and 2007, finding its complement in section 4, which presents the Central Bank view and the macroeconomic policies actually put into practice.

Section 5 presents the growth record of the period and the constraints the macroeconomic policy puts on growth.

The last section suggests some interpretations of the Brazilian case on the light of recent development theory and of the experience of other countries.

2) Setting the stage: Uncertainty and change in 2003

In every culture the first day of the year is heavily laden with the symbolism of renewal but, in Brazil, the first of January of 2003 was truly exceptional: it was the Inauguration Day of President Lula, elected by a coalition of parties led by the Workers Party (PT).

Lula’s life seems come out a Hollywood scenario of the fifties: an immigrant from one of the poorest regions of the country, who starts, as a child, by selling oranges on the street, moves on to become a skilled worker, becomes a leader of one of the most important trade unions in the State of São Paulo, the main Brazilian industrial center. In the latter capacity he became an outstanding critic of the military regime. In 1981 he founded, with other trade union leaders, left wing politicians and intellectuals the PT and thereafter became a full-time politician. So reads his official profile at the site of the Presidency. Two important facts are omitted from the scenario. First, his skills as a negotiator, which made possible his success as a union leader and later as head of the PT, a party riddled with tendencies. Second, his appreciation of the economic success of
the “Miracle” period of the military regime (1968-73) which led to full employment in the State of São Paulo³.

With such background Lula stood out as novelty in the Brazilian political scene, in stark contrast, for instance, with his two predecessors, Collor and Cardoso, the former a scion of a traditional family of entrepreneurs and politicians from the Northeast and the latter coming from the upper middle class of Rio and São Paulo. The media repeatedly pointed out his lack of formal education and his grammatical mistakes, comparing them to the fluency in other languages of his predecessors and the great academic prestige of Cardoso. Small wonder that Lula insists over and over on the importance of education for the people.

If Lula was a novelty, not less was the PT. For the first time Brazil had a textbook political party – an institution with a militant membership, connected to the many social movements directed to the under-privileged – landless peasants, slum dwellers, Indians, etc. A grass-roots party with a strong tradition of internal debate, the PT had forcefully promoted the idea of participatory democracy⁴. It was stronger in the more developed parts of the country and weaker in the Northeast and North regions, where the more traditional “clientelistic” politics prevailed. To make it worst, the PT defined itself as “socialist”, although what was meant by socialism was not altogether clear. In its 2001 Congress it laid down “rupture with the prevailing model” as its main electoral plank.

By 2002 it was the fourth time Lula was a candidate for the Presidential seat. At the first time, in 1989, he was defeated by a narrow margin by Fernando Collor de Melo – a vote well summarized by Luciano Martins (1990) as the vote of “protest and fear”. Protest against the lost decade and fear of the former worker. In the following election (1994) he lost to Fernando Henrique Cardoso who, as Finance Minister, had supervised the stabilization plan which brought the period of high and sustained inflation to an end. During the campaign the media suggested repeatedly that Lula would undo the Real Plan. Finally, in 1998, Cardoso got reelected, in spite of a looming foreign exchange crisis, stemming from its policy of keeping the real overvalued to curb internal prices. Uncertainty about how the PT would manage the crisis and the still

³ In a 1997 interview Lula said that the General governing such period would have won a free direct election (Costa Couto, 1999).
⁴ As exemplified by the budgeting process in some of the cities it administered, such as Porto Alegre, host to the Social Forum, the rallying point of anti-globalization movements throughout the world.
positive results of price stability for the poorer strata of the population played an important role in this outcome.

In 2002 the candidate from Cardoso’s party tried to play, once again, the fear card. The external conditions favored the game: the world economy was still reeling from September 11 and the dot.com debacle, Argentina was plunged into its deep debt crisis and war on the Gulf was imminent. In institutions where Lula electors were few the fear became operational: foreign investment dried up, the real devalued, and inflation estimates for the next year shot up. A clear signal was given to the candidate and his team. The response was prompt, if ambiguous: in mid 2002, in a widely publicized statement (the Letter to the Brazilians) Lula, while reiterating the need to “change the model”, committed his future government to “respect the contracts”. Albeit with less publicity he also put out bridges to the “market” institutions, such as the powerful Banks Federation (FEBRABAN).

All cards worked partially only. On the one hand, the market indicators continued to deteriorate sharply during the second semester of 2002. On the other the population, besieged by low growth, high unemployment and, to cap, it by an energy crisis, elected Lula. As he put it: “hope gained over fear”.

Therefore, at the first of January of 2003, in Brazil, the hopes for renewal were tinged with considerable uncertainty about the future. Among economists there were some points which were consensual: the need to resume growth and employment and to go back to some price stability and the constraints on both objectives posed by foreign exchange scarcity and infra-structure (especially energy and transports) availability. Consensus stopped there: there was a wide array of dissent, going from whether the focus should lie on the productive structure (as in developmental times) or on institutions (as the neo-liberals argued), to the relative role State and market should play. Some specific solutions to the problems of stability and growth, such as the reform of the Social Security System, the formal independence of the Central Bank, the control of financial foreign capitals and the need for an industrial policy were especially

---

5 A detailed description of the 2002 crisis can be found in the Open Letter of the President of the Central Bank to the Finance Minister explaining why the inflation targets of 2002 were not met. Meirelles, 2003
6 The energy crisis was a result of the combination of limited rainfall and of the hasty privatization of the sector, sold out to foreign investors to get precious foreign exchange. It contributed in no small way to demoralize the second Cardoso government.
7 See Rennô and Spanakos (2006) for an analysis of the backward looking behavior of the Brazilian electorate.
divisive. A clear indication of the course the new Government intended to take was urgently needed.

3) Development Projects Galore

On January first 2003 President Lula made two Inauguration speeches: one to the festive huge crowd assembled in front the Planalto Palace and another, longer and more formal, at the Congress.\(^8\)

Addressing the Congress, Lula reiterated that “change was the key-word”, that the previous model was defunct. Nonetheless, change had to be gradual, pursued with patience and perseverance. To do so, he stressed, a national development project was necessary, as well as a strategic planning.

Such project should be directed primarily to the needs of the underprivileged – it should focus on the provision of education and health and, above, all, on hunger. As a result, he expected an improvement on the self-esteem of the Brazilian people.

As means to such objectives he stated the need for macroeconomic stability and, specifically, a responsible management of public finances. Growth would be a result of an increase in savings and investment, including here human capital. The focus would lie on the internal market, especially on small and medium-sized enterprises, on infrastructure and on technological capability. A wide range of institutional reforms was mentioned: social security, fiscal, agrarian, labor legislation and political. In order to carry on such ambitious program he pleaded for a “social pact” uniting labor and capital in order to generate a “solidarity energy”.

On the international front he also intended to introduce changes. Regionally, he intended to ascribe top priority to South America. Tradewise, he wished to reduce the protectionism of the more industrialized countries and increase the technological content of Brazilian exports. Foreign direct investment was welcome but its role was not emphasized - a substantial change as regards the Cardoso government, when foreign investment was seen as the demiurge of development.

Silence is as eloquent as speech. Financial capital, be it foreign or local, is not even mentioned. Political parties are given short shrift too. Notwithstanding a cursory bow to the PT on the speech at the Palace and a mention to the need of a political reform, what

---

\(^8\) The 2003 and 2007 Inauguration speeches may be found at the site of the Presidency (www.presidencia.gov.br)
is stressed is the direct relationship between Lula and the “people”, in which he sees himself as embodying the dreams of generations and posits a family-type relationship.

Designed to build consensus the Inauguration speeches left plenty of scope to different interpretations, as shown by two important ensuing documents, published in early 2003. The Finance Ministry (Ministério da Fazenda, 2003) toed the line by stating that the “social inclusion” was the central axis of a “new development cycle” but made the point that the level of social expenditures made by the Brazilian State was already high – the problem was that such expenditures (notably transfers associated with social security) had “non-poor” as beneficiaries. In other words, social policy in Brazil was inefficient. To remedy that, policies directed to social inclusion should focus on the “poor” only, in opposition to the traditional PT view that social policies should be “republican and universal”.

As expected, the Finance Ministry reiterated that inflation control was essential and put emphasis on the fiscal policy to stabilize prices. Moreover, priority should be given to institutional reforms which would have as their “unifying theme” the “importance of institutional and legal development for the appropriate working of markets and public policies”. New Institutional Economics was a clear inspiration to the Finance Ministry team, which specified their four priority reforms: two were directly geared to fiscal problems: social security and fiscal reform itself, the other two to the financial system: the legal autonomy of the Central Bank and the reinforcement of the rights of creditors, assuming that the latter would then reduce interest rates.

Almost simultaneously, the Planning Ministry published the “Directives” for the new 2003-2007 Investment Plan of the Federal Government (Ministério do Planejamento 2003). The social objectives of the Government would be achieved by a virtuous circle between the demand of workers’ households for consumer goods and investment, leading to productivity increase, lower prices and more exports. The virtuous circle required an increase of the real wage of workers’ families. However, given the scarcity of jobs and market failures which reduced the transfer of productivity growth to wages, policies were required to compensate for such failures. As a consequence, the “social” objectives of inclusion and reduction of inequality would converge with the “economic” operation of the virtuous circle.
The reading of Keynes by Furtado, who strenuously and repeatedly[^9] warned that the Keynesian virtuous circle would not arise spontaneously under the conditions of underdevelopment, lies behind the Plan.

Differences with the MF document go further. The State, here, has a stronger role – “leader of the social and regional development and inducer of the economic development”. As regards institutional reform, while sharing the consensus on the need for reforms of the fiscal and social security systems, the Plan ascribes little importance to the improvement of creditors rights and does not even mention the autonomy of the Central Bank.

Later on, the two Ministries would agree on the institutional solution for the problem of investment in infra-structure: public-private partnerships, whereby the state would guarantee a minimum rate of return to private investors. Widely touted by a consulting firm, such institutional device elicited little enthusiasm among private investors[^10].

Once again, silence is eloquent. It is remarkable that the concern with efficiency (Finance Ministry) and with the role of the State (Planning Ministry) did not lead to a proposal of State administrative reform, especially as regards the thorny problems of coordination, monitoring and evaluation of policies. Quite the contrary, the Government implemented the “social pact” idea in the most traditional way: multiplying the number of councils and fora in which sit entrepreneurs, workers and State officials. The latter are usually members *de officio* but the former two are normally co-opted on the basis of their personal prestige or indicated by institutions. Notwithstanding their rhetorical role and the fillip they provide to the egos of invited members, such councils have little efficiency value and often are counterproductive[^11].

Finally, still in 2003, the Government announced its Directives for industrial policy (Ministerio da Indústria e Comércio, 2003). In fact, a policy which embraced industrial and technological development and foreign trade – a novelty by itself. The policy

---

[^9]: This issue transverses all the work of Furtado since the early sixties (e.g. Furtado, 1961).

[^10]: As a Director of the National Development Bank I interviewed entrepreneurs who had already engaged in such partnerships abroad as well as potential investors in Brazil. All were quick to point out the legal, financial and operational difficulties facing such ventures and considered that their use in Brazil would be limited in scope and take a long time to implement. I passed on this information to colleagues in Brasília but it did not seem to abate their enthusiasm with PPPs. I assume they talked to other people.

[^11]: Last time I counted, there were seven Councils involved with the industrial policy.
(PITCE) was predicated upon innovation and reduction of trade deficits. The two were linked by the difference in the technology intensiveness of Brazilian foreign trade and by the related income-elasticity. Since Brazilian exports have a lower technology intensiveness than imports and because it was assumed that income-elasticity was correlated with technology intensiveness, the conclusion was that the foreign trade structure had a built-in deficit, since the growth rate of imports would tend to be higher than the rate of growth of exports – a view which harks back to the famous Prebisch-Singer thesis.

Such diagnostic of foreign trade constraint was not highly contentious. Much less was the emphasis on innovation – a meeting ground of economists of all persuasions, from endogenous growth to evolutionary economics. In fact, it is not surprising that the teams of Finance and Planning found here a matter of agreement.

Where PITCE introduced noise was in its sector selectiveness – by choosing four sectors as priorities it harked back to the Developmental State, where sector policies were paramount. The sectors selected were technology intensive and bearers of large trade deficits: software, electronic components, capital goods and pharmaceuticals, to which were added two pervasive technologies, dubbed “future carriers”: nanotechnology and biotechnology. Later on, biomass was added to the list. Although pharmaceuticals could be justified in terms of its social importance, the rationale of PITCE was not dependent on its direct impact on “social inclusion”.

To sum it up, during the first year of the Lula government we had at least three different interpretations of his call for a “development project”. This ambiguity precluded the “strategic planning” he argued for in his Inauguration speech of the first mandate. The macroeconomic policy later described compounded the difficulties.

Four years later, reelected but with no festive crowd in front of the Palace, he made a new Inauguration speech at the Congress. The underprivileged continued to be its priority, but “change”, now, should be “fast”. The “strategic vision of development” and the “social pact” were to be based on the twin pillars of public and private investment, directed mainly to a Program to Accelerate Growth (PAC). As soon became clear the

---

12 As later events showed, such analysis underestimated the weight on the Brazilian export performance played by the “China factor” and the ensuing increase in the demand for primary products and manufactures of low technology intensiveness

13 I must “declare an interest”: I was part of the group which prepared the PITCE and was responsible for its implementation at the National Development Bank during 2003/4. Moreover, I am unashamedly sector-oriented as far as industrial policies go.
latter is essentially a large program (more than R$ 500 billion, i.e. US$ 290 billion) of investments in infra-structure, of which about 55% would go to energy projects, a third to urban infra-structure and the rest to logistics.

If well succeeded such Program would reestablish the old developmental pact, in which coalesced the whole chain of supply of constructions goods and services, suppliers of capital goods and workers (mostly with low educational requirements).

4) The compromise: macro-economic and social policies

In practice, the Lula government implemented bits and pieces of all the projects outlined above. We shall initially comment on the 2003 projects, leaving the comments on the 2007 project after a description of the macroeconomic policy.

Fiscal and social security regulations were changed in order to provide incentives to private investment and to reduce retirement and pension expenditures. Foreign investment in public debt securities also got fiscal incentives.

The financial system got the increased protection of creditor’s rights and, at least as important, the right to lend money to private individuals with the payment of the debt being deducted from their monthly wages (i.e. a payroll-backed low-risk credit).

As regards PITCE, budget allocations and credit incentives for innovation and for strengthening the relationship between enterprises and universities and research centers increased. Fiscal and credit incentives to investment were provided too.

However, the evolution of international demand for raw materials (e.g. iron ore) and for semi-manufactured goods (e.g. steel slabs) eliminated the foreign exchange constraint and dampened the enthusiasm for technology-intensive sector policies, which have lingered. In fact, Brazilian trade policy has been directed more to expanding markets for products already exported rather than to diversifying the range of exports (Pinheiro and Bonelli, 2007). Significantly, in the course of the Doha Round negotiations Brazil offered to further reduce tariffs on manufactures in exchange for a reduction by the advanced countries of protection given to primary products. On the import side, the policy of keeping a low exchange rate to brake inflation has increased imports of technology-intensive products, as predicted by PITCE, but this is seen by macro policy-makers as a bonus, since such imports should lead to short-term productivity gains, as stressed by the Finance Ministry in its 2003 document.

In other words, the role of PITCE as a vector of change of the productive structure has been reduced and its instrumentality turned to a more canonical “horizontal” lineage. In development theory terms, the emphasis has shifted from a developmental
neo-schumpeterian approach to an endogenous-cum-natural-comparative-advantage growth.

From the bits and pieces above mentioned, emerges a conservative slant. Change is indeed very gradual and conforming to established interests.

However, in my reading of it, the main thrust of the Lula government is to be found in the compromise between social policies, designed to achieve its economic and political objectives of improving the lot of the underprivileged and orthodox macro-economic policies which benefit the financial coalition.

Social policies had two main strands. The first is the provision of basic services, such as electric power (*Programa Luz para Todos*) and funds for primary education (*FUNDEB – Fundo de Desenvolvimento da Educação Básica*). The second, and more relevant, is the transfer of income to economically destitute households (*Bolsa Família*) and the increase of the minimum wage.

*Bolsa Família* (Family Grant) provides between R$ 18 and R$112 (US$ 10 and US$64) per month, depending on the conditions of the family. In 2007 it benefited around 11 million families (about 46 million people). As a counterpart to the transfer, children must attend school and be inoculated against diseases and pregnant women must undergo pre-natal care. About half of the beneficiaries are located in the Northeastern region of the country and, for them, it is estimated that Bolsa Família increases their revenue by close to 60% - a testimony to the low earnings of that population (Globo OnLine 26/12/2007).

Minimum wage, defined yearly, was raised by the Government by an average of 8.1% in real terms over the period 2003-2006 and by 4.4% in 2007. Its impact goes way beyond employees, since most social security benefits are indexed to the minimum wage (Giambiagi 2007).

The populations which benefit from Bolsa Família and rise of the minimum wage are not the same, economically. Looking at the income distribution of the country by deciles, the beneficiaries of BF are concentrated in the first (poorest) tenth while minimum wage earners are concentrated on the third tenth (Sabioa 2007).

As a consequence, macroeconomic effects of the two policies are distinct. As regards consumption, Bolsa Família increases mainly the sales of wage goods – it is not by accident that sales of supermarkets have increased most in the Northeast and North regions, where the program benefits a substantial part of households. The
increase in the minimum wage, coupled to an increase in employment and to credit expansion (see below) has fuelled a boom in sales of durable goods.

Their fiscal impact is also very distinct. Bolsa Familia, together with the other, older, transfer programs account for less than 1% of GNP in 2006 while the increase in minimum wage affects directly the social security bill and, more indirectly, the wages paid by the public sector (Giambiagi 2007). In fact, from 2008 onwards, rises of the minimum wage have been indexed to the increase of the GNP.

Finally, the two policies have complementary political effects – it is not surprising that in the 2006 election the regions which benefited most from the social policies provided the bulk of the votes which led to Lula’s victory.

Let us now look at macro-economic policies. At the beginning of the Lula first mandate, there was no doubt that a firm stance on macroeconomic policies was necessary to bring back to normality the financial and foreign exchange markets, which had erupted in the second half of 2002. The government complied with such expectations with textbook orthodoxy: the National Monetary Council set severe fiscal and inflation targets and let the foreign exchange fluctuate, with no capital or import controls.

The rationale of this policy is well-known: price stability is a condition for sustainable growth. Stability creates an environment in which relative prices play their allocation role efficiently, fiscal and private accounting systems are trustworthy and long term contracts and funding can be signed in confidence. In other words, the objectives of stability and growth are complementary. No questions about the distributive consequences of relative prices are asked. It is a view shared by the Brazilian Central Bank with its counterparts all over the world.\textsuperscript{14}

The doubt was: would this tough and orthodox policy simply be a transition to more heterodox policies, such as advocated by many Brazilian post-keynesian economists and put into practice in the post-crisis Argentina, or would it be permanent? Those who bet on the second alternative won.

To better understand Brazilian macro-policy it is helpful to explain some of its institutional traits. Although there are many Councils where the policy is discussed, decisions are taken by the National Monetary Council. The latter is composed by the

\textsuperscript{14} For the U.S. Fed and the European Central Bank see Artus (2007), for the Brazilian Central Bank Bevilaqua et al. (2007).
Ministers of Finance and Planning and the President of the Central Bank. Of the two Ministers, the former is incomparably more powerful. Although the Central Bank did not get its ambitioned legal independence, its President was awarded Ministerial status during the first Lula government.

In mid-year, the Monetary Council sets fiscal and monetary targets for the calendar year two years ahead. Nonetheless, under special circumstances the Central Bank may modify the inflation target. Fiscal objectives are set in terms of the primary surplus. This target puts a damper on public investment and on the indebtedness of State-owned enterprises but leaves a wide space for the monetary policy since it does not include interest payments. Monetary targets are expressed by a wide consumer-price index. The full index is used, in spite of the weight (about 30% of the index) of prices which are pegged to other indexes, such as the price of utilities. The exchange rate fluctuates but the Central Bank may intervene.

The Central Bank, which has a considerable say in the setting of the inflation target by virtue of its presence in the Monetary Council and its connection to the Finance Ministry, then enjoys full autonomy to set the interest rates which it deems necessary to achieve the goal - the decision is taken by a Committee (COPOM) composed only by Central Bank executives.

As explained by two of its members: “COPOM guides its policy decisions by its own forecasts for inflation in the relevant time horizon and the respective balance of risks. Market expectations of inflation are important inputs in the BCB’s forecasting models… Expectations, in turn, have been influenced by past inflation behavior, the inflation targets, exchange rate and commodity price developments, economic activity and the stance of monetary policy” (Bevilaqua et al. 2007, p.5). They believe that the

---

15 Part of the great power wielded by the Finance Ministry derives from a peculiarity of the Brazilian fiscal institutions. The yearly budget is prepared by Planning Ministry in consultation with other ministries (its main function nowadays), it is submitted to Congress, which has the power to amend it, and then it sanctioned by the President. Nevertheless, the budget is not mandatory: the Finance Ministry has the authority to reduce expenditures which are not legally earmarked (such as constitutional transfers to States). This provides a great scope for discretion in payments and it is, incidentally, a major source of political wrangling between the Executive and Legislative.

16 The inflation target has an admissible range of variation around its targeted centre, which shrunk from plus or minus 2.5% during 2003-2005 to 2% since then.

17 In January 2003 the Central Bank considered the situation critical and adjusted the targets for 2003 and 2004 (to 8.5% and 5.5%).

18 IPCA, which includes consumers with up to 40 times the minimum wage.

19 This is another result of privatization: since one of its main objectives was to attract foreign investors, their rates were pegged to price-indexes in which the foreign exchange rate was more influential. The recent valuation of the real has played into the hands of the Central Bank.
“backward-looking component of market expectations has been ceding ground to the inflation target, evidence that the IT system is gaining credibility”. However “credibility has not been perfect, so oftentimes inflation expectations seem to have over-reacted to current developments, in particular to upward inflation surprises. Thus the BC often had to act so as to prevent negative short-term developments from contaminating the medium-term outlook. In this sense the process of disinflation has been, and still is, a process of taming inflation expectations” \( (ibid) \).

The authors stress the importance of inflation expectations held by the financial sector but do not seem to worry about the possibility that the forecasts of the financial institutions may be influenced by the higher returns such institutions earn when the Central Bank raises its rate.

If the Central Bank fails to reach the target, its President has to write a public letter to the Finance Minister explaining this failure. Minute of COPOM meetings are available at the site of the Central Bank (bancocentral.gov.br) but such transparency does not apply to the Monetary Council.

Let us now take a look at the actual policies. As regards fiscal policy, the primary surplus targets were achieved: over 2003-2007 primary surplus was, on average, 4.1% of GNP, the highest average of a government since the mid-eighties, albeit at the cost of increasing the tax burden from 32 to 35% of GNP (Giambiagi 2007). In 2007 the CMN excluded some public investment related to the PAC (amounting to 0.5% of GNP) from the primary surplus target.

As for inflation targets, they were also achieved, except in 2003. Moreover, in 2006 the rate of inflation was lower than the center target, a result repeated, less brilliantly, in 2007 when the inflation (4.46%) was slightly below the target (4.5%). Table 1 compares the target with the actual inflation rate over the period 2003-2007 and shows the declining trend of inflation, which testifies to the success of the macro-economic policy (in its own terms).

<table>
<thead>
<tr>
<th>YEAR</th>
<th>TARGET</th>
<th>RANGE</th>
<th>INFLATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>5.5</td>
<td>+/- 2.5</td>
<td>9.30</td>
</tr>
<tr>
<td>2004</td>
<td>5.5</td>
<td>+/- 2.5</td>
<td>7.60</td>
</tr>
<tr>
<td>2005</td>
<td>4.5</td>
<td>+/- 2.5</td>
<td>5.69</td>
</tr>
<tr>
<td>2006</td>
<td>4.5</td>
<td>+/- 2.0</td>
<td>3.14</td>
</tr>
</tbody>
</table>
How were such results achieved? First of all, by a tight monetary policy. The real basic interest rate (Selic) was, on average, 11.3% per year over the 2003-2006 period. Even after its decline in 2007, it still averaged 7.6% in real terms (Giambiagi, 2007), one of the highest in the world. Private financial investors get rates similar to Selic from the banks but the latter charge borrowers a multiple of this rate - according to the Central Bank, at the end of 2007 the average interest rate charged to private enterprises was twice the value of Selic and to private individuals about four times higher (Banco Central 2007). Given such spread, it is not surprising that banks are the most profitable business in Brazil. Such high lending rates have, in turn, led many enterprises to look for alternative sources of funding, either issuing bonds or stock, leading to a boom in both markets.

Not all borrowers pay the high interest rates mentioned above. Loans for investment granted by the National Development Bank (BNDES), loans to rural producers (mainly cooperatives and small farms) and housing loans enjoy lower interest rates, set by the Monetary Council. Such earmarked credits amounted to around 10% of GNP in 2007, of which BNDES accounts for about 60%, agriculture for 23% and housing 16%. “Free’ credit (in Central Bank parlance) granted by the private financial sector has increased from 18% to 24% of GNP from 2003 to 2007, especially for personal credit (Banco Central, 2007).

BNDES is practically the sole internal source of long-term credit for investment. Its budget of about US$ 33 billion makes it one of the largest development banks in the world. It operates directly, in large operations, and mostly via a network of 180 private financial institutions, which earn a del credere in such loans and enjoy the indirect benefits of a banker-client relationship with the borrowers. The Monetary Council set the nominal basic rate for BNDES at 11% per year during 2003, cut it down to 9.75% during the two following years and, to foster private investment gradually reduced it since 2006 to the present 6.25% p.a. Loans for agriculture often face repayment problems and their main provider is another public bank, the Banco do Brasil. A third public bank (Caixa Economica Federal) plays an important role in housing finance.
The Central Bank would like to transfer all earmarked resources to the “free” market, under the rationale of increasing the credit availability and thus, supposedly, lowering interest rates. The financial system, a closely knit and well-oiled oligopoly, would like to get such funds too, but without any obligation to fulfill the roles played by the public banks. Since the latter are irreplaceable, the Government has resisted the combined pressures of the Central Bank and the financial system.

Within this broad framework, over the 2003-2007 period the Central Bank has conducted the monetary policy in a see-saw pattern, raising and cutting down the basic rate. As shown in Graph 1, below, the Central Bank increased the basic rate in the beginning of 2003 to countenance the upsurge of inflation of the second semester of 2002 and kept it at high levels until the middle of the year, when lower inflation expectations led to a period of reduction of the basic rate, which lasted until September 2004.

As explained by two COPOM members, in the middle of 2004, there was “(h)eightened uncertainty regarding the external scenario thanks to the looming Fed tightening… and current and expected real depreciation” and “(a)s of mid 2004 the economy was growing by about 5% pa, after two quarters expanding 7% pa, signaling that the output gap was probably closing. Moreover, indices of capacity utilization in manufacturing were above average values, in some sectors actually reaching unprecedented levels. Clearly, these signs suggested…an economy where firms faced favorable conditions to increase their prices” (Bevilaqua et al. 2007 p.9). A rise of the basic rate was duly implemented which lasted for a year. Accordingly, GNP growth rate fell from 5.7% in 2004 to 2.9% in 2005.

In September 2005 another period of reduction got under way, which lasted until the last quarter of 2007, when the sub-prime crisis led the Bank to halt it, setting the rate at 11.25% per year. Graph 1 below illustrates this movement, using the overnight-SELIC rate – i.e. the rate negotiated between the Central Bank and the financial system.

Graph 2 – Selic-Overnight Interest Rate - % per month – December 2002 – December 2007

20 A sort-lived episode, as shown in Graph 2 below.
Monetary policy found a complement in foreign exchange rate evolution. The high and sustained interest rates and the expansion of the securities and stock markets, above mentioned, aided by fiscal incentives to international investors, attracted a massive and increasing inflow of financial capital, especially from 2005 onwards. Such inflow, coupled to the current transaction surplus, led to the valorization of the real, shown in Graph 2, which, in turn, places a damper on prices of tradable goods.

Graph 2 - Real exchange rate 2003-2007

---

21 *The Economist* (25/10/2007) estimates that some 70% of the money for recent IPOs has come from foreign investors.
Note: Monthly nominal exchange rates deflated by the General Price Index (IGP)
Source: IPEAdata

5) The doubtful path of growth

Table 2 shows the rates of growth of Brazilian GDP and of its demand components over the period 2003-2006 and Central Bank’s estimates for 2007 and 2008\textsuperscript{22}. Its standard interpretation is that it sums up the two phases of the period as regards growth leaders: from 2003 to 2005 growth was export-led and in the two following years (and the current year) leadership shifted to internal demand. As argued below, such view underestimates the role exports continue to play.

Table 2 – Brazilian GDP and its Demand Components – Yearly growth rates 2003-2007 and forecast for 2008 – in %

<table>
<thead>
<tr>
<th>YEAR</th>
<th>GNP</th>
<th>Household Demand</th>
<th>Govt. Demand</th>
<th>Total Consumption</th>
<th>Capital Expend.</th>
<th>Exp.</th>
<th>Imp.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>1.1</td>
<td>- 0.8</td>
<td>1.2</td>
<td>- 0.3</td>
<td>- 4.6</td>
<td>10.4</td>
<td>- 1.6</td>
</tr>
<tr>
<td>2004</td>
<td>5.7</td>
<td>3.8</td>
<td>4.1</td>
<td>3.9</td>
<td>9.1</td>
<td>15.3</td>
<td>13.3</td>
</tr>
<tr>
<td>2005</td>
<td>3.2</td>
<td>4.5</td>
<td>2.3</td>
<td>3.9</td>
<td>3.6</td>
<td>9.3</td>
<td>8.5</td>
</tr>
</tbody>
</table>

\textsuperscript{22} Given the role of the Central Bank, I decided to use their figures.
5.1) Consumer demand

Household demand depends on three factors: employment, earnings and credit. Table 3 shows the evolution of employment, average real earnings of employed persons, total wage earnings and the real minimum wage for the period 2002/2006, based on the yearly National Household Survey (PNAD) of the Statistics Institute (IBGE).

Table 3 - Employment, Real average earning of employed persons, total earning of persons employed, real minimum wage (1) – 2002-2006 index numbers

<table>
<thead>
<tr>
<th>Year</th>
<th>Employment</th>
<th>Earnings of employed persons</th>
<th>Total earnings</th>
<th>Real minimum wage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>2003</td>
<td>102.4</td>
<td>92.5</td>
<td>91.8</td>
<td>100,70</td>
</tr>
<tr>
<td>2004</td>
<td>106.5</td>
<td>92.5</td>
<td>93.9</td>
<td>104.45</td>
</tr>
<tr>
<td>2005</td>
<td>109.1</td>
<td>96.7</td>
<td>103.0</td>
<td>111.72</td>
</tr>
<tr>
<td>2006</td>
<td>112.3</td>
<td>103.7</td>
<td>113.2</td>
<td>127.42</td>
</tr>
</tbody>
</table>

Note: Average yearly minimum wage deflated by the restricted consumer price index - INPC
Source: PNAD and IPEAdata

Between 2003 and 2006 the number of persons employed increased by 9.1 million, mostly in manufacturing industry (1.6 million) and commerce (1.5 million). Moreover, formal employment increased – from 50% to 55% of total. Bearing in mind that about two-thirds of the new jobs created in the period covered by the Table was paid between one and two minimum wages (IEDI 2008), Table 3 suggests that the expansion of consumer demand in 2005 and 2006 (see previous Table) is strongly associated with the large nominal increases in the minimum wage given in 2005 (7%) and, especially, 2006 (14%). In 2007 the minimum wage increased by 6% and although the results of PNAD are not yet available, the information from the monthly surveys of
six metropolitan areas done by IBGE indicate that employment has continued to grow, supporting the consumer demand growth.

The rise of the minimum wage has been guided mostly by political considerations. A long-standing complaint of entrepreneurs is that labor legislation multiplies the wage, introducing rigidities in the labor market – hence the need for reform. The Finance Ministry ratified this claim in its early 2003 document above mentioned. Therefore, it is not surprising that the Central Bank worries about the possible inflationary effects of wage increases. Its last Inflation Report (Banco Central 2007) brings a detailed study of the evolution of unit cost of labor for manufacturing industry from January 2003 to September 2007, comparing changes in the total average labor cost (in nominal terms) per hour worked with changes in the per hour productivity of labor. Its conclusions are cautious: first, “inflation pressures coming from the (industrial) labor market have not emerged yet” (p.124) (emphasis added) and, second, the aggregate cost of labor may be more inflationary, since the industrial market is disciplined by international competition, contrary to services. From this year onwards, the rise of the minimum wage is pegged to the increase of GNP.

It is worthwhile to put such growth of earnings in a longer term prospective. As shown by Saboia (2007) the real minimum wage has gone back to level of the seventies (the “Miracle” period, of which the President is an enthusiast in economic terms), but still a third below its peak at the end of the fifties. As regards personal earnings, there are no such extended time series but Table 4 shows that the recovery imparted by the Lula government has but put back such earnings to a more “normal” level – a coming back from the 2003 crisis, but still below the 1996 peak.

Table 4 – Average monthly earning of employed person – 1996-2006 – Index numbers

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Earning</td>
<td>100</td>
<td>98.9</td>
<td>96.1</td>
<td>91.1</td>
<td>90.1</td>
<td>87.9</td>
<td>81.2</td>
<td>81.2</td>
<td>84.9</td>
<td>91.1</td>
</tr>
</tbody>
</table>

Note: PNAD was not performed in 2000
Source: DIEESE/PNAD

The expansion of consumer demand has been also fuelled by credit, similarly to the years of the “Miracle”. As mentioned above, the Central Bank reduced its basic rate form September 2005 and continued to cut it down until the last quarter of 2007. The private financial system reacted by cutting down the interest rate for loans to private
individuals not backed by payroll ("free" credit) but by less than the Selic reduction\textsuperscript{23}. As a consequence, credits to consumers became relatively more profitable than lending to the Government. At about 45\% per year, with inflation a tenth of that value, loans to individuals increased their share of total credit from 31\% at the end of 2005 to 34.3\% two years later (Banco Central 2007). To further stimulate borrowing, banks extended the duration of loans\textsuperscript{24}. Moreover, the regulation of payroll-backed loans opened a huge market to the banks. According to some estimates (see Folha On Line 8/1/2008) such loans increased by 35\% in 2007. Although they are charged lower interest rates (a paltry 29\% per year) they offer a very small risk to the lenders. It is not surprising that the profits of the three main commercial banks for the three first quarters of 2007 exceeded their total (and huge) profits of the previous year.

The typical behavior of Brazilian consumers is to check if the monthly installments they have to pay for a loan to buy a durable consumer good “fits” into their monthly disposable income, not bothering with the interest rate they are charged. On the other side, retail chains which sell durable and semi-durable consumer goods, auto dealers and realtors are loath to sell for cash, since they have long-established relationships with the financial system and earn considerable profits from the finance. Consumer debt is higher in the group earning from one to three minimum wages. The level of non-compliance of overall consumer debt increased substantially in 2005 and 2006 (13.5\% and 10.5\%) but stabilized in 2007 (1.7\% increase) (Globo On Line 17/01/2008 and 21/1/2008).

This debt-driven consumer expansion is no novelty in Brazil – it fits the observed historical pattern of consumer behavior and it is strongly reminiscent of the expansionary period of the late sixties and seventies. Politically, it broadens the social base of support of the Government by including the middle stratum of income which is not included either in the fiscal transfers of the Bolsa Família or in the rentier group. Nonetheless, given the level of disposable income of the majority of households it is a rather frail base to support sustained growth.

5.2) Investment

\textsuperscript{23} According to an estimate of the finance executives association (ANEFAC), in 2007 Selic was reduced by 43\%, while the interest rate for loans to individuals fell by 10.5\% only. Folha OnLine 15/1/2008

\textsuperscript{24} The average personal loan in September 2006 was granted for 331 days. A year later it had been extended to 419 days (IEDI 2008)
Let us now turn to investment. As shown in Table 2, capital expenditures are the fastest growing demand component over the last two years. Once again, it is convenient to place this into perspective. Investment share of GNP in Brazil fell from 20.7% in 1994 to a low 15% by the middle of 2003. Its recent growth puts it back to around 18% of GNP – a substantial increase but which still leaves the stock of capital growing at a 2.5% per year, insufficient for sustaining a fast expansion of GNP.

The low investment rates observed over the recent past cannot be disassociated from the macro-economic policy of high interest rates which has prevailed during its long period of decline. Such policy leads private investors to a portfolio where the hurdle rate of projects is heightened, since financial investment provide high alternative rates of profit and the financial cost of fixed and working capital is increased. Moreover, the short-term horizon and the remarkable fluctuations of the basic interest rate bias the investment portfolio towards projects with a short pay-off period. The valorization of the exchange rate, twin brother of the monetary policy, reduces the incentive to invest in activities which are geared to exports or import-substitution.

The Lula government has tried to compensate for such negative incentives deriving from the macroeconomic policy by granting fiscal incentives to investment and by reducing the basic interest rate charged by BNDES.

Squeezed in between interest payments and inflexible current expenditures and facing a stiff primary surplus target, State investment has languished – over the period 2003-2006 the Federal government invested no more than 0.6% of GNP. The other governments (states and cities) invested another 1.4% of GNP. This is less than what was invested during the liberal period (1990-2002). It is estimated that in 2007 there would be a slight increase in those paltry figures – 0.2% of GNP for the federal government and 0.1% for the other governments (Giambiagi, 2007). Since the tax burden seems to have reached its political limit, the Finance Ministry decided to exclude some investments (0.5% of GNP) from the primary surplus target in order to get the above mentioned infra-structure plan (PAC) under way.

Who invests under such circumstances? Tables 5 present a breakdown of Brazilian capital formation in 2005, by sector.

Table 5 – Gross capital formation in Brazil by sectors - 2005 – In %

25 Investment at current prices. IPEA data
26 Estimated by IPEA (2007)
A comparison of the components of capital formation in Brazil and OECD countries (Puga and Nascimento 2007) shows that the main difference lay in the share of construction (housing and non-housing). This confirms the consensus that those two areas are major problems. Housing deficit is estimated at 8 million units and concentrated on families which earn less than three minimum wages. Infrastructure limitations are evident in the appalling conditions of the transport and warehousing systems, in the chaotic conditions of airports and, last but not least in a possible forthcoming energy shortage, which threatens to repeat the 2001 crisis.

As regards housing, in 2007 circa 200 thousand units were financed but credit versus income remains a major stumbling block. The Lula government set new regulations strengthening creditors’ rights and has increased the budget of the Federal bank in charge of housing. Some building companies, which cater for the higher end of the consumer market have taken advantage of the stock exchange boom and have increased their own capital. Nevertheless, total credit for housing is still very limited – less than 2% of GNP, much lower than other similar countries such as Mexico, Chile and South Africa – and its cost is out of reach of low-income customers (Torres Filho and Puga, 2007).

The Government responded in the beginning of the new mandate with the PAC. The Program estimates that 86.5% of the programmed investment is to be evenly shared between State-owned enterprises (mainly Petrobras and Eletrobras) and private companies, with the balance going to the Federal government. As shown below Petrobras is pursuing an ambitious energy investment program and Eletrobras has substantial resources of its own, investing about 0.2% of GNP (Giambiagi 2007). To elicit the private investment the Government set up a special fund for infra-structure with para-fiscal resources and BNDES has reduced the interest charged for such projects. Moreover, the Federal Government set up a complex system for monitoring the projects included in the Program.

<table>
<thead>
<tr>
<th>Infrastructure</th>
<th>Housing</th>
<th>Industry</th>
<th>Mining</th>
<th>Oil</th>
<th>Govt.</th>
<th>Others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>22</td>
<td>14</td>
<td>3</td>
<td>7</td>
<td>11</td>
<td>32</td>
<td>100</td>
</tr>
</tbody>
</table>

Notes:
(1) Government excludes infrastructure
(2) Others include agriculture and non-infrastructure services
Source: BNDES

A comparison of the components of capital formation in Brazil and OECD countries (Puga and Nascimento 2007) shows that the main difference lay in the share of construction (housing and non-housing). This confirms the consensus that those two areas are major problems. Housing deficit is estimated at 8 million units and concentrated on families which earn less than three minimum wages. Infrastructure limitations are evident in the appalling conditions of the transport and warehousing systems, in the chaotic conditions of airports and, last but not least in a possible forthcoming energy shortage, which threatens to repeat the 2001 crisis.

As regards housing, in 2007 circa 200 thousand units were financed but credit versus income remains a major stumbling block. The Lula government set new regulations strengthening creditors’ rights and has increased the budget of the Federal bank in charge of housing. Some building companies, which cater for the higher end of the consumer market have taken advantage of the stock exchange boom and have increased their own capital. Nevertheless, total credit for housing is still very limited – less than 2% of GNP, much lower than other similar countries such as Mexico, Chile and South Africa – and its cost is out of reach of low-income customers (Torres Filho and Puga, 2007).

The Government responded in the beginning of the new mandate with the PAC. The Program estimates that 86.5% of the programmed investment is to be evenly shared between State-owned enterprises (mainly Petrobras and Eletrobras) and private companies, with the balance going to the Federal government. As shown below Petrobras is pursuing an ambitious energy investment program and Eletrobras has substantial resources of its own, investing about 0.2% of GNP (Giambiagi 2007). To elicit the private investment the Government set up a special fund for infra-structure with para-fiscal resources and BNDES has reduced the interest charged for such projects. Moreover, the Federal Government set up a complex system for monitoring the projects included in the Program.
At the end of 2007 the Government assessed that most projects were running according to schedule, an evaluation strongly denied by the press, which pointed out that many important projects were in fact far behind schedule and that less than 30% of the planned expenditures by the Federal Government had been actually performed. Such mishap seem to be due mainly to institutional difficulties, such as conflicts over the environmental impact of the projects and coordination between the Government and regulatory agencies.

Underneath such apparent governance difficulties lay deeper and unresolved questions regarding the role of the State in Brazil and the weight to be attached to objectives and timing.

As for the first, the Lula government inherited an incomplete transition from a State which was principal and agent to a State which delegated regulation to specialized agencies. In other words, the change from a developmental State to a liberal one was never completed. During the Lula years privatization was halted and the relationship between Executive and regulatory agencies has been strained (Central Bank excepted) but political and legal considerations have prevented a reversal of the process. The stalemate continues and its cost is paid in terms of poor governance and slower growth.

As for the second, there are strong conflicts within the Government and society about the relative to be attached to different objectives, such as fast capital accumulation and ensuing growth, on the one hand, and protection of the natural environment and international reputation on the other. Again: although the first objective has tended to predominate this is not followed up by the necessary institutional changes, leading to a process in which both objectives get thwarted: slower and lessened growth and limited environment protection.

In other words: the project to grow by infrastructure investment is hampered by political and institutional ambiguities, which, in turn, relate to the absence of a development convention. Such difficulties coalesce with the constraints imposed by the macroeconomic policy.

Investment in agriculture, as indicated by production of capital goods for this sector\footnote{As indicated by IBGE data, available at http://www.sidra.ibge.gov.br.} has followed the international market, mediated by the exchange rate – it
increased in 2003 and 2004, took a deep dive in 2005 and 2006 with the exchange rate valorization, but came back in 2007, led by favorable crop conditions.

As for industry and mining, Table 6 below shows estimates of investment over the 2003-2006 and 2008-2011 periods, covering the sectors which account for 70% of total industrial investment (Puga and Borça Jr., 2007).

**TABLE 6 – Investment in Brazil by sectors: 2003/06 and 2008/11 – In R$ billions**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>OIL &amp; GAS</td>
<td>126.3</td>
<td>50.64</td>
<td>202.8</td>
<td>45.37</td>
<td>9.9</td>
</tr>
<tr>
<td>ALCOHOL</td>
<td>13.3</td>
<td>5.33</td>
<td>20.5</td>
<td>4.59</td>
<td>9.0</td>
</tr>
<tr>
<td>MINING</td>
<td>38.0</td>
<td>15.23</td>
<td>81.3</td>
<td>18.19</td>
<td>16.4</td>
</tr>
<tr>
<td>STEEL</td>
<td>17.6</td>
<td>7.05</td>
<td>31.2</td>
<td>6.98</td>
<td>12.1</td>
</tr>
<tr>
<td>PULP &amp; PAPER</td>
<td>10.9</td>
<td>4.37</td>
<td>27.4</td>
<td>6.13</td>
<td>16.5</td>
</tr>
<tr>
<td>PETROCHEMICALS</td>
<td>5.7</td>
<td>2.28</td>
<td>26.4</td>
<td>5.91</td>
<td>36.1</td>
</tr>
<tr>
<td>AUTOMOBILE</td>
<td>22.3</td>
<td>9.14</td>
<td>35.0</td>
<td>7.83</td>
<td>9.5</td>
</tr>
<tr>
<td>ELECTRONICS</td>
<td>9.5</td>
<td>3.81</td>
<td>14.0</td>
<td>3.13</td>
<td>8.1</td>
</tr>
<tr>
<td>PHARMACEUTICALS</td>
<td>3.9</td>
<td>1.56</td>
<td>5.1</td>
<td>1.14</td>
<td>5.6</td>
</tr>
<tr>
<td>SOFTWARE</td>
<td>2.0</td>
<td>0.80</td>
<td>5.1</td>
<td>0.74</td>
<td>5.6</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>249.4</td>
<td>100.0</td>
<td>447.0</td>
<td>100.0</td>
<td>12.4</td>
</tr>
</tbody>
</table>

Source: BNDES
Note: sum may not total 100.00 because of rounding up.

As shown above, investment over the 2003-2006 period was concentrated in five sectors: oil and gas (50.6%)\(^{28}\), mining (15.2%), steel (7%), pulp and paper (4.4%) and petrochemicals (2.2%). Estimates for 2008-2011 indicate that the same sectors will increase their share to 83% of the total. Those are scale- and natural resources-intensive

---

\(^{28}\) Investment for alcohol production is for energy purposes, with an eye on the external market.
sectors, where projects are highly capital-intensive\textsuperscript{29}, performed by large enterprises with access to foreign supplier credits, which tend to import a substantial part of their equipment, reducing thus their linkage to locally established machinery suppliers. Such investments are geared to import-substitution-cum-exports (oil and gas and petrochemicals) and to build scale-competitive plants in order to maintain market share in a growing world market (mining, steel and pulp and paper).

Therefore such estimates suggest that investment is still being led by the external sector. As shown by NEIT(2007) commodities and industrial products of middle technology-intensiveness accounted for about two thirds of total export growth over the 2002-2006 period, an evolution which is consistent with the pattern of investment observed above. The valorization of the exchange rate provides a negative incentive to such investment which, so far, was compensated by the high prices such products have fetched in the international market and by the intense competition prevailing in such markets, which obliges participants to invest in order to remain competitive and maintain market share.

According to the same study, investment in durable consumer goods (automobile and electronics) accounted for 13\% of total in the period 2003-2006 and is expected to contribute 10\% of the total increase in investment for 2008-2011. Since capacity utilization of manufacturing industry has increased, reaching a record of 83\% in October 2007\textsuperscript{30}, it is possible that sectors directed to the internal market will boost their investments. However, the data so far available does not point to a virtuous circle of consumer induced-investment growth.

Two other indicator strengthen such conclusions. The fastest growing capital goods branches are those which supply equipment for the energy sector and for construction\textsuperscript{31} and labor productivity in manufacturing industry is increasing slowly (at less than 2\% per year) and such growth slackened during 2007 (Banco Central, 2007).

The virtuous circle is further enfeebled by the incentives the macro economic policy gives to use external sources of supply of finance and equipment, via high

\textsuperscript{29} To give but two examples: the petrochemical pole which is planned to use the heavy oil extracted by Petrobras has a cost estimated at around US$ 10 billion; a new state-of-the art pulp plant in Bahia US$ 2.1 billion (values in R$ converted at R$1.8/US$). Data from Torres Filho and Puga (2007)

\textsuperscript{30} Data of the National Industry Confederation (CNI) reported in the minute of the COPOM meeting of December 2007

\textsuperscript{31} The two types of capital goods account for 9\% of the total capital goods sector as measured by IBGE (http://www.sidra.ibge.gov.br). Transport equipment and “capital goods for several sectors” are the most important components.
interest rate and overvalued exchange rate. Imports of capital goods and intermediary products far above the growth of local production explain the fast growth of imports shown in Table 2. Such imports warm the heart of the Central Bank: they ease the inflationary pressures by rapidly increasing production capacity and total factor productivity. Nonetheless, reliance on imports to supply production goods fits better in the virtuous circle of an export-driven growth than in the virtuosity of consumer-investment growth. In fact, as shown above, the bulk of industrial investment is related to the external sector.

5.3) Big Brother is watching

The preceding analysis has highlighted the limitations the macroeconomic policy led by the Central Bank poses on the two growth regimes now envisaged by the Government Lula – consumer-led expansion and autonomous infrastructure investment. Moreover, the policy reduces the incentive to invest in sectors which are geared to exports and/or import substitution, which actually are the main investors in Brazil. Not all difficulties stem from the policy, but the latter plays a significant role in the debate about the roles of the State and the market in directing decisions by firmly taking the side of the latter.

The power of the Central Bank in the Brazilian context goes further – it can break an expansionary cycle, as shown by the 2004 episode and it may repeat its feat in the near future.

The previous long quote of two members of COPOM is pertinent since the conditions which led to the rise of the basic rate in 2004 are very similar to those prevailing now. In fact, some are more worrisome than three and half years ago. The international scenario is certainly much worse. It is not a tightening of the Fed policy which is at stake but a major crisis with the USA economy at its epicenter. At the same time, the foreign exchange rate and the increase in imports help to keep inflation down and it may be argued that most external indicators of Brazil have improved: international reserves have trebled since 2003 and are now equivalent to 18 months of imports, as compared to 12 months in 2003, the ratio net debt over exports fell to 0.56 and is less than 7% of GNP and, last but not least, Brazil represents a much smaller risk in the eyes of investors than it did in 2004.

32 In heyday of liberalism in Brazil, 1995/97, the President of the Central Bank, Gustavo Franco argued forcefully for such a pattern of development. See Franco (1998)
As regards the internal inflation pressures, the degree of capacity utilization is now higher than it was in mid 2004. It is true that investment has increased recently, more than it had in 2003-2004 but consumer demand has also expanded more. As a consequence the Bank is becoming more edgy about capacity utilization, as shown by the COPOM minutes. Such documents tend to repeat themselves so additions and subtractions are relevant. Comparing the published minute of the meetings held in October 16-17 and December 4-5\textsuperscript{33}, one reads in paragraph 21 of the two documents the acknowledgement of the role played by external factors and investment in the fight against inflation but in the last document it is added, in the typically convoluted style: “in this context, the consistent reduction of the difference between the rhythm of growth of the supply of goods and service and [the rhythm] of demand becomes even more relevant to the evaluation of the possibilities which are presented to the monetary policy”.

It is unlikely that such a statement will accelerate investment decisions, since the latter are taken in firm-specific contexts – a classical problem of collective action. Nonetheless it warns readers that the COPOM may raise the basic rate. As a consequence it increases the uncertainty about the evolution of demand and, paradoxically, may induce behavior of “wait and see” as regards investments directed to the internal market, which will reinforce COPOM’s fears in the future, producing a vicious circle for growth.

In other words, to the uncertainty stemming from the international situation is added the uncertainty deriving from the power of the Central Bank.

But where from does this power come?

The traumatic experience of inflation during the period which goes from the failure in 1986 of the Cruzado plan of stabilization based on price controls, which enjoyed enormous popular support, to 1994, when the Real plan finally achieved price stability certainly plays an important role to provide legitimacy to the Central Bank, which presents itself as the “guardian of stability”. No Government can afford to be seen as being “lenient” toward inflation and thus the Central Bank finds important allies within the Government, starting with the Finance Ministry, which plays a major role in

\textsuperscript{33} 130\textsuperscript{th} and 131\textsuperscript{st} Meeting. At the time of writing (end of January) the minute of the 23-23\textsuperscript{rd} January meeting had not been published yet. See Banco Central (2007)
the monetary policy through the fiscal policy it establishes. Such alliance, as shown above, is institutionalized in decisions and operation of the National Monetary Council.

It is often argued that price stability has the nature of a public good, in the sense that nobody can be excluded from its benefits but the policy above summarized has some very specific losers and winners. Among the former, borrowers come top of the list. The main borrower is the State\textsuperscript{34}, which paid out a yearly average of 7.3\% of GNP over the period 2003-2006 on account of interests (Giambiagi, 2007). The amount spent for Bolsa Familia pales in comparison: it is less than a tenth of interests. By keeping the primary surplus high and freeing thus funds for interest payments the Finance Ministry plays a major role in this process of resource distribution.

On the other side of the coin, the winners’ side, stand the lenders. Among them, the financial system is *primum inter pares*: the consolidated balance of banks shows that over the 2003 to 2007 period the volume of net profits of the system trebled and their rate of profit increased from 14.8\% in 2003 to 22.9\% in 2007 (Valor Económico, 2008). Nonetheless, the financial system does not stand alone. Institutional investors, such as pension funds, insurance companies, cash-rich enterprises\textsuperscript{35} benefit too as do the households of the upper tenth of the income distribution, which receive about 45\% of the national income, and especially those who belong to the upper 1\%, who get a hefty 13\% of the national income\textsuperscript{36}. Bruno’s (2007) figures for the *rentier* share of national income show that non-financial enterprises and individuals received, on average, 81\% of the total *rentier* share over the period 1995/2005.

As mentioned above, over the last two years the basic interest rate paid the State has declined more than the rate paid by private consumers, leading to a substantial expansion of credit to private borrowers and to even greater profits to the financial

\textsuperscript{34}Net internal public debt has increased from 37\% to 52\% of GNP over the 2002-2007 period and its bonds are now wholly denominated in *reais*, since the valuation of the exchange rate eliminated the attractiveness of foreign-currency-denominated bonds and the positive results of the balance of payments allowed for a repurchase of such bonds. As a result, the external indebtedness of the Brazilian government was drastically altered: from an external public debt equivalent to 13\% of GNP in 2002 to a credit of 8\% of GNP in 2007. Such change reduced total net public indebtedness from 30\% in 2002 to 44\% of GNP in 2007.

\textsuperscript{35}For example, industrial enterprises which produce intermediary products, agricultural commodity producers, retail chains, utilities suppliers.

\textsuperscript{36}Brazil is notorious for the inequality of its income distribution. Available measurements underestimate the share of the upper strata (and the inequality) because of underreporting of property income such as rent and interest. There is a consensus that inequality was reduced slightly during the Lula period – the Gini coefficient fell from 0.583 in 2003 to 0.569 in 2005. All figures form IPEA data.
system. Such change may have altered the distribution of gains among the winners but not the composition of their side.

The definition of losers and winners is not a new phenomenon, since very high interests have been in force since the debt crisis of the early eighties. My assumption is that over this long period a coalition of interests was formed, structured by the public debt and the high interests earned on such debt. Such coalition operates under a tacit agreement that the Brazilian State has to pay high interests and so must do other debtors. In other words, there is a convention firmly grounded on powerful interests about the payment of interest rates.

Original sin arguments, such as the external debt moratorium of 1987, are often offered as justification, which, in turn, make the award of “investment grade” rank by agencies of risk evaluation equivalent to redemption of that sin. Such facts as the role of the US Fed in the foreign debt crisis, or the lower rates now paid in countries which started world-wide crises, such as Mexico and Russia, are conveniently forgotten. Notwithstanding the substantial fiscal surplus achieved since the end of the nineties, the State current expenditures are also brought forward to justify the interest rate the State has to pay. More recently, high interest rates have been justified by institutional “failures” such as the limited protection given to creditors and the earmarked credit. As shown above, the Lula Government hastened to remedy the former but its consequences in terms of interest rate reduction remain to be seen.

Such coalition of private interests has powerful instruments to convey its messages. The most explicit lay in the hands of the financial system, as exemplified by the crisis of the second semester of 2002 which so effectively tamed the incoming government. But there are other instruments, not so explicit, such as the financing of political campaigns\(^{37}\) and the connections to Congress members. The waning of the prestige of the Executive since the debacle of the developmental State in the eighties certainly helps.

The Central Bank is a necessary member of this coalition – it is the institution which conceives and implements monetary policy and the financial sector is its agent. Notwithstanding the growth of government bonds holdings by foreign investors, their

---

\(^{37}\) See Filgueiras and Gonçalves (2007) for the contributions of the financial system to the candidates to the Presidential elections of 2002 and 2006
local currency denomination tends to strengthen the links between the Finance Ministry, the Central Bank and the local financial system.

The Bank’s participation in the coalition does not imply a “capture” in public choice fashion – it suffices that the Central Bank and the private members of the coalition derive joint benefits from the same policy. For instance, it is plausible to suppose that the recent reluctance of the Central Bank to increase the basic rate may be influenced by the high profits the financial system is earning with the present credit boom, which, in turn, increase the “soundness” of the system.

Power is a very strong driver and after the Real Plan the Central Bank has enjoyed enormous power. During the first Cardoso government (1995-1998) it imposed its quasi-fixed over-valued exchange rate policy, in spite of the opposition of very powerful interests (e.g. exporters, local industry besieged by import competition), even within the Government itself. Such power was increased under the inflation-targeting system adopted after the predicted foreign exchange crisis came true. Within the Lula government such power is even greater. Such power is justified by a technocratic pride in performing a role which is seen as pedagogic and therapeutic – “taming inflation expectations” say the COPOM members – no matter how much the medicine hurts.

The cohesion of this coalition is strengthened by a conservative bias: private interests want to preserve the highly profitable status quo, the Central Bank wants to preserve the price system. Both oppose structural changes which would alter wealth and income distribution and relative prices, increasing the risk of inflation. As a consequence the coalition uses its power not only to foster policies in its benefit but also to veto policies which may alter the status quo. “Development projects” which may lead to structural changes are therefore excluded.

The cohesion is further strengthened by how monetary policy is implemented. The Central Bank has, as every regulatory agency does, to keep close and continuous contacts with the agents it regulates. Such contacts are formal and informal and they contribute to fashion a “common knowledge”. The use of the inflation expectations of the financial institutions to calibrate the Central Bank own expectations is but an example of this process.

---

38 I thank Robert Guttmann for bringing this point to my attention.
Such “common knowledge” is strengthened by keeping the policy horizon short. Inflation targets are set a year and a half ahead and COPOM meetings, where the policy may be changed, are held every forty days and are preceded by innumerable statements in the press by members of the financial community about their expectations about the COPOM decision.

As already pointed out, this produces substantive uncertainty over the long and short run. Such uncertainty and the short horizon are antithetical to the formation of a long-term development convention.

Finally, the cohesion of the coalition is strengthened by a shared belief in the legitimacy of the “market” to be the main institution in charge of organizing and driving the economy and the society. Such belief legitimates the use of their power to veto projects and policies which may reduce the power of the market in favor of other institutions. As such, the range of feasible development projects is severely restricted.

In this respect, the unresolved crisis of the State plays into the hands of the coalition. The developmental State, which led the country for thirty years up to the end of the seventies, agonized during the eighties, losing legitimacy as growth petered out and inflation soared. The neo-liberal years, from 1990 to 2002, introduced some important changes, such as privatization of most State-owned enterprises but baulked at the prospect of introducing major political and administrative reforms which would make the State more politically representative and capable of a better governance.

Constrained politically at the Congress as it was economically by the above mentioned coalition, the Lula Government opted for an equally conservative strategy as regards the State. The relationship between the Executive and Legislative powers remained the same, participation of the civil society was translated into co-optation, a tradition going back to the thirties, and the reform of the system of political party system has been as cautious as it can be. Although space precludes a fuller discussion of such issues, it seems fair to conclude that the political strategy of the Government has reinforced the financial coalition, undermining further the Government efforts to launch a long term development project.

---

39 Given the legislation on natural resources and the creation of large State-owned enterprises in steel and mining, one could argue that a developmental State was already existent during the forties.
6) Conclusions

To sum it up, the preceding analysis argued that the Lula government put forward several development projects, implemented bits and pieces of such projects and has conducted a policy which benefits mostly the two extremes of the income range. The macroeconomic policy followed by the Government limits all the long term development projects and has a built-in conservative bias against structural change.

I suggest that a political economy approach can help to understand such phenomena. More specifically, I suggest that a powerful coalition between private interests and the Central Bank developed over the last quarter of century, especially after the mid-nineties, which has the power to impose policies which benefit it and to veto alternative policies. The deadlock about the reform of the State has strengthened this coalition. Path-dependency and cumulativeness are strong factors in such process.

The international conditions which prevailed from the beginning of the Lula government until the last quarter of 2007 favored the macroeconomic policy it adopted. Their change to the worse following the sub-prime crisis will reinforce the restrictive aspects of such policy.

The analysis is centered on the Brazilian case. Although this case presents some extreme features, such as the high interest rates charged and the income distribution, it is but one of a species.40 Similar macroeconomic policies are practiced in most developed countries, Central Banks have adopted inflation-targeting as their best practice and the consequences are the same. Moreover, in countries where there was a strong tradition of State intervention, such as France, the stalemate about the roles of the market and State seem to be very similar to the Brazilian one.

To conclude, a comment on development theory. We all know the remark of Keynes about “practical men” being guided by long-dead economists. Theory, as history, matters.

I have equated above a “development project” to a “development convention”. The latter is to be understood as a cognitive device, shared by the hegemonic decision-makers, which is used to establish a positive and a negative agenda: which problems come first and which solutions to such problems are legitimate. Such conventions are

---

40 In their comments to an earlier paper, François Chesnais and Fernando Cardim drew my attention to this point. I thank them for it. On the policies of Central Banks in developed countries and their implications for growth see Artus (2007).
made up by codified and tacit knowledge – theories about economics, politics and sociology belong to the first group and myths to the second. I have argued elsewhere (Erber, 2002) that tacit knowledge plays an important role in development but here I will concentrate on a specific branch of codified knowledge – economics.

The days in which Fukuyama proclaimed the “end of History” and Williamson dubbed the Washington Consensus the “Universal Consensus” which “summarized the common core of wisdom embraced by all serious economists” are long past. They have been superseded by the international crises of the nineties, the failure of showcases such as Argentina and the success of heterodox paths of development followed by China, India and Vietnam, among others. Gone are also the laundry-lists of institutional reforms to be applied *urbi et orbi* to promote “good governance” and thus to transform Zambia into Sweden overnight. “Big bangs” lost their gilt. Given their results the demise of such conventions should be commemorated.

Diversity, a hallmark of old developmentalism, has made a comeback: countries follow different trajectories. Institutions change gradually, the polity plays an important role in institutional change, institutions may be formally identical and operate differently depending on their context. Political economy is back, “history matters”, path-dependency and cumulativeness are important. Even “industrial policy”, that bad word, has had a reprieve by none less than the World Bank (2007).

However, behind the recognition of diversity and the caution about general recipes, lies unabated the belief in the need for “sound fundamentals”. This is an expression with strong rhetorical power (as was “rational” expectations) because nobody is in favor of “unsound” fundamentals. The problem lies in how one defines “soundness”.

The canonical answer now is fiscal equilibrium, low inflation and flexible exchange rate. Given soundness and a well working price mechanism, growth will follow suit. If it doesn’t it is either because some institutions are not working properly (each case is different) and they should be reformed bearing in mind the context or/and because path dependency leads the agents to hold bad expectations about inflation. To remedy the latter, stick to your guns and keep firing until expectations change and a new trajectory is established. It takes time but, as one humorist has put it, “in the end all will

---

41 See Fukuyama (1989) and Williamson (1993, p.1334)
be well and if it is not well yet it is because it has not ended”. The Central Banks have become the high-priests of this canon and to fulfill their role they must be free and independent.

Such definition partakes the faith on the market with the neo-liberal convention, but it is much more sanguine about macro-economic policy, as it takes a firmer stand on monetary and foreign exchange policies. Moreover, as mentioned above, its scope is more limited and its horizon shorter than the ones put forward by the neo-liberal convention.

Nonetheless, we have a “soundness” convention, with all its attributes. But, is it a development convention? In so far as development is interpreted as implying structural change and a long term prospective, the answer is negative. The developmental convention focused on changes in the productive structure, the neo-liberal convention on the institutional structure. Both had a long term horizon. The “sound” fundamentalists focus on stability and it looks, at best, at the near future only. It is, in this sense, essentially conservative, especially where the interests it serves are being well-cared for. The Brazilian case illustrates how well it works.

REFERENCES

Folha On Line (15/01/2008) – “Taxas de juros têm redução em dezembro, aponta ANEFAC”
Globo On Line – (17/01/2008) – “Inadimplência aumentou 1,7% em 2007, mostra SERASA”
Filgueiras, (2007) –
Ministério da Fazenda (2003) – Política econômica e reformas estruturais, Brasília
Ministério do Planejamento e Orçamento (2003) – Plano Brasil Para Todos , Brasília